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SUBJECT: PRELUDE TO 2009 JEDG MID-TERM REVIEW

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Classified By: Economic Counselor David Burnett for reasons 1.4 b/d

SUMMARY

¶1. (SBU) Ahead of the December Joint Economic Development Group (JEDG) mid-term review, Econoff met with contacts at the Bank of Israel and the Ministry of Finance to assess progress on several of the key issues raised in the June 2009 JEDG meeting in Washington. While strong consensus remains among GoI economic players on the need for a fiscal rule which correlates the debt-to-GDP ratio to expenditures, there has been little movement towards a unifying equation in part because of a lack of urgency -- the additional planning time provided by the 2009/2010 two-year budget. The current expenditure ceiling of 1.7 percent, which has been in place since 2007, succeeded in restraining spending and lowering the debt level, but is now considered by most too restrictive. There is less agreement on the creation of a budget oversight mechanism, the future of a two-year budget, and the usefulness of further tax reductions. Amid the planning for the JEDG mid-year review, Israel's final steps toward accession to the OECD remains a major focus for our interlocutors while preliminary third quarter economic data (septel) points to further economic recovery. We expect GoI presentations at the mid-term review to show that Israel is well within the range of fiscal and budget targets set out in the 2009/20101 LGA conditionality. The December 15, 2009 JEDG meeting will also principally serve as a platform for the GoI to pursue expanded dialogue on high-tech development and relate the tale of the economy's steady recovery. End summary.

NEW FISCAL RULE: NO RUSH

¶2. (SBU) From recent meetings with contacts at the Bank of Israel and the Ministry of Finance's Budget Office, the consensus on the desirability of a new fiscal rule that relates to the debt trajectory remains clear. However, real progress in discussions among the Bank of Israel (BoI), the Ministry of Finance (MoF) and the National Economic Council (NEC) on the formulation of the new rule remains elusive. The impetus to move forward quickly has been negated by the current two-year budget, which relieves much of the time pressure inherent in yearly budget submissions. The MoF projects a fully-vetted joint proposal on a new rule by mid 2010, just in time for the 2011 budget discussions. The Budget Office believes the current gaps are minor, and the final decision will be the Prime Minister's. Dr. Karnit Flug, Head of the BoI's Research Department, emphasized to Econoff the broad consensus to reduce the debt-to-GDP ratio. Despite the economic crisis that has caused rising debt-to-GDP ratios in many countries (due in part to huge stimulus packages), she believes that Israel should remain on

the reduction path towards 60 percent, as it is a useful shock absorber in times of crisis. With the U.S. ratio heading toward 140 percent by 2020, Israel looks comparatively better at 80 percent projected for 2010, she noted.

BALANCING EXPENDITURES AND TAXES

¶3. (C) Our interlocutors have expressed little enthusiasm for the Prime Minister's desired tax cuts, in line with the November 19 OECD announcement that "scheduled cuts in corporate and personal taxation for 2010 are untimely." The PM's reductions would require a very tight spending framework, sacrificing needed social expenditures that have suffered greatly in recent years. BoI and the Ministry of Finance see difficult times ahead in the formulation of the 2011 expenditure budget. The 1.7 percent expenditure target that served Israel so well in reducing its large debt is now widely considered too restrictive. Flug says the BoI could support a more gradual debt reduction course that would allow perhaps a three percent expenditure growth rate. Eyal Epstein of the MoF Budget Division noted that a return to the 1.7 percent target in 2011 would effectively limit expenditures to a 0.35 percent increase (after eliminating the more expansive ceiling of 2009/2010), clearly an untenable situation. He expects a combination of an increased expenditure ceiling and retention of deficit ceiling in the 2011 budget, although he said the NEC, BoI and MoF currently differ slightly on where the expenditure target should be by about 2-3 billion NIS (USD 500 million - 800 million.) The three organizations are currently discussing a

debt formula by which the expenditures would be loosened as the target 60 percent debt-to-GDP ratio is neared. The deficit figure for the first 10 months of the year indicates that the actual deficit will come in below the target of 6 percent, NIS 44.4 billion (USD 12 billion), ending the year at about 5% of GDP for 2009. While public expenditures now account for 42 percent of GDP, down from 50 percent in 2003, Epstein believes that greater efficiency is paramount. Agreeing that a decrease in the defense budget might produce greater efficiency, he told Econoff that a more serious discussion of the defense budget is required.

NOT READY FOR SUBSTANTIVE BUDGET OVERSIGHT

¶4. (C) There seems to be no consensus on concrete steps toward significant budget oversight among the three primary economic actors. Karnit Flug told Econoff that meaningful oversight would require the creation of a professional body and there is currently no chance that the necessary funds would be allocated for this enterprise. However, she continues to support a more inclusive budget process which would require the MoF to enhance its dialogue with the various ministries. While the Ministry of Finance appears to be the player with the most to lose in a scenario of increased budget oversight, the Budget Office's Eyal Epstein told Econoff that Dr. Udi Nissan, the Budget Director, favors a stronger partnership between the MoF and the spending Ministries than has existed in the past regarding the entire budget process. While Epstein agrees that the subject expertise within the Ministries could be valuable in improving the budget process, it is important to emphasize the objective role of the MoF in maintaining the larger budget priorities. Lacking this comprehensive picture of the State's goals, the involvement of individual ministries often creates conflict. Therefore, parameters are required to focus involvement in the most useful areas of the budget production process. Epstein noted that in his experience working with spending ministries, there is often a reticence to engage in the process of developing the budget, except to push for larger allotments.

¶5. (C) The role of the Knesset's Finance Committee in the budget process also needs improvement, according to Epstein and Flug. While not proscribing an oversight role for the Committee, both noted that the budget discussions could be more serious and professional. Klug said that Committee members are not provided with sufficient independent analysis and discussions too quickly turn political. The Governor of the Bank occasionally makes presentations to the Committee, but the BoI is not normally present at the Committee's budget discussions. Epstein had praise for several members of the committee that he considered well-versed in the subject matter and serious about the overall budget, including Haim Oron of the Meretz party and current Committee Chairman Moshe Gafni.

¶6. (C) The jury is still out on the success of the two-year budget, but the MoF appears cautious about continuing the two-year model despite the Minister's unreserved praise for it. Noting that the second half of 2009 is only the fist half year of the budget's performance, Epstein said the budget needs to be judged on more than just its appealing convenience. He confirmed that a restructuring of the budget is on the agenda for 2011-2012, but declined to be specific. He did address criticisms of the Economic Arrangements Bill, (a omnibus bill originally designed to provide adjustments to the budget to support targeted reforms such as increasing competition and improving efficiency), noting that while it can be extremely useful in times of economic crisis, it currently lacks focus and dilutes adherence to the government's key priorities and reform efforts.

¶7. (C) Comment: The JEDG 2009 midterm review is well timed for the GoI to showcase evidence of Israel's improved economic performance with the BoI's recent interest rate increase and the release of strong preliminary third quarter data (to be reported septel.) Perhaps this tide of good fortune could open the door to a discussion of a mutually-agreed early end of the 2003 Loan Guarantee Agreement (set to fully expire in 2012) thereby absolving both parties of the need to contemplate the statutory reductions that any use of the guarantees would necessitate. We expect no alterations to the LGA conditionality agreement, and the GoI has clearly signaled a desire to refocus the Joint Economic Development Group toward more strategic economic dialogue and away from prescriptions for fiscal

discipline. While the midterm review will also address broader economic issues of concern to the U.S., including the pace of Israel's structural reforms and privatizations, and the trade implications of the country's food safety standards, the GoI wants the focus to be on the discussion of their proposed U.S.-Israel high-tech dialogue (see reftel). While we remain unconvinced that the JEDG is the proper vehicle for pursuing greater high-tech cooperation, we do not see an alternate forum that would provide sufficient emphasis on our perceived "special" bilateral relationship to satisfy the GoI. We welcome Washington's assessment of the future of the LGA and JEDG, and suggest using the margins of the midterm review to gauge the Israeli position on re-assessing the economic dialogue.
MORENO